# Fiscal Impact of SB 1467:

## *Conflict of Interest and Related Issues in State Contracting*


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# Summary

The fiscal impact of SB 1467 on state agencies may be non-existent or significant, depending on how the Department of General Services (DGS) interprets the law, and how the law is ultimately interpreted by the courts. A strict interpretation could result in missed deadlines on federally mandated projects that could subject the State to penalties of hundreds of millions of dollars in addition to increased contracting costs. The California State University (CSU) has incurred minor costs to promulgate new policies, and will continue to incur minor administrative costs to enforce the new policies. The University of California (UC) will incur costs estimated at $4.4 million to $15.2 million annually. The broad and absolute language of the law has created uncertainty and concern, which could be mitigated by administrative guidance, an exemption process, exemption of the UC's construction program and medical centers from one provision, and modification of another requirement.

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# I. Purpose of Study

Under SB 1467 (Chapter 1122, Statutes of 2002), certain provisions of existing law regarding conflict of interest and contract-related penalties were applied more broadly within state agencies and were extended to the CSU and the UC. During deliberations over the bill, concern was voiced by representatives of the information technology (IT) industry and by UC that the bill would increase the costs of contracting. To address these concerns, a requirement was added to the bill that the Department of Finance study and report on the bill's likely fiscal impact.

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# II. Background

## A. Issues Addressed in SB 1467

SB 1467 deals with the following five previously existing provisions of the Public Contract Code (PCC):[1]

1. **Follow-On Consulting Contracts.** Consulting services contractors and subcontractors (with more than 10 percent of the dollar amount of the contract) may not bid on or be awarded a contract to provide goods, services or related actions that were recommended, suggested or otherwise deemed appropriate in the end product of the consulting services contract (PCC Section 10365.5).

2. **Financial Conflict of Interest.** State officials may not contract with any state agency on their own behalf or engage in any compensated employment or activity funded by a state contract (PCC Section 10410). (For example, a state employee with an outside business may not contract with any state agency.)

3. **Revolving Door.** For period of one year after leaving state service, a former state official who was in a policy-making position may not enter into a contract with the former agency in the same general subject area in which the official was employed. For a period of two years after leaving state service, a former state official may not enter into any contract in which the official participated in the development, negotiation, or decision-making (PCC Section 10411).

4. **Penalties.** Contracts involving substantive violation of statutory provisions or procedures are void. Willful violation of contracting laws is a misdemeanor, and corrupt violation of contracting laws or contracts is a felony (PCC Sections 10420-26).

5. **Contractor Identification Number.** Requires a unique vendor identification number on each contract over $10,000. In the case of a firm or corporation, the "president's assigned number" shall be used (PCC Section 10412).

Prior to SB 1467, the provisions described above applied only to state agency contracts for non-IT goods and services. Although these statutory provisions did not apply to IT for state agencies, the DGS applied some of the provisions to IT via the State Administrative Manual (SAM) and contract documents. For the CSU and UC, the statutory provisions did not apply to either IT or non-IT goods and services contracts (although non-IT

[1] Many conflict of Interest provisions in state law are complex and require interpretation, often on a case-by-case basis.

goods and services contracts within the CSU were covered by these provisions prior to 2002[1]).

## B. Other Statutory Provisions

Prohibitions against conflict of interest have a long history in common and statutory law. The following sections of the Government Code (GC) address financial conflict of interest and revolving door issues, and to some extent overlap with SB 1467, although there are significant differences. These laws focus on situations that disqualify an individual from taking certain actions.

- GC Section 19990 prohibits a state officer or employee from participating in any activity or employment that is incompatible with the employee's duties to the State, and specifies numerous prohibited activities. This section does not apply to the UC or CSU.

- GC Section 87100 prohibits a public official from participating in a decision in which he or she has a financial interest. GC 1090 prohibits a public official from participating in a contract in which the official has a financial interest; such contracts may be voided, and the official is subject to a fine and imprisonment.

- GC Section 87401 permanently prohibits a former public official from being compensated to assist or represent another entity for the purpose of trying to influence a legal or administrative proceeding involving a specific party in which the individual had previously participated. (For example, this section would prohibit a former official from being paid to testify against his or her former agency regarding an issue in which the individual had participated.)

- GC Section 87406 prohibits a former public official, for a period of one year, from being paid by another entity to communicate with the official's former agency in order to influence a decision (e.g., regarding a contract). A former official is not prohibited from communicating on his or her own behalf; thus, this section would not prohibit a former employee from being awarded a contract.

[1] Chapter 219, Statutes of 2001, exempted CSU from state contracting laws governing non-IT goods and services. Prior to this statute, the CSU was governed by most of the same laws as state agencies for non-IT goods and services.

## C. Comparison to Federal Regulations

Prohibiting organizational and consultant conflict of interest is a well-established principle in the federal government. The federal government has rules that govern its own agencies and provide a useful comparison to State rules. Rules governing state agencies that receive federal funds complement state laws, and are part of the environment in which state laws operate and are sometimes interpreted.

**Rules Applying to Federal Agencies.** Federal agencies are subject to the Federal Acquisition Regulation (FAR), which provides general principles as well as clear instructions regarding specific situations.[2] The general principles are to prevent conflicting roles that might bias a contractor's judgment and to prevent unfair competitive advantage (e.g., possession of proprietary or otherwise unavailable information).

FAR rules are not absolute, but allow for flexibility under a variety of circumstances, for example:

- A contractor that prepares specifications is not allowed to furnish or produce the items "for a reasonable period of time," including the initial contract period, unless the government agency requested information about the contractor's products or the contractor assisted a government agency and was under the supervision and control of the government agency.

- A contractor that prepares a work statement is ineligible to provide the services, unless the contractor is the sole source, or more than one contractor prepared the work statement.

- A federal agency may issue a contract where an organizational conflict of interest exists, if the agency takes steps to avoid or mitigate the conflict and the contract's benefits and detriments to the federal government have been considered.

**Rules Applying to State Agencies, CSU, and UC.** State departments engaging in federally funded IT projects must follow State IT contracting laws, and are also subject to federal regulations that are intended to promote open competition and prevent organizational conflict of interest. The federal regulations would also apply to the CSU and UC when they engage in similar federally funded projects. These regulations are established by program area in the Code of Federal Regulations (CFR). For example, the Department of Social Services (DSS) is subject to these federal requirements:

[2] See Federal Acquisition Regulation, Subpart 9.5, at www.arnet.gov/far/current/html/Subpart_9_5.html.

- Contractors that develop or draft grant applications, or contract specifications, requirements, statements of work, invitations for bids, and/or requests for proposals shall be excluded from competing for such procurements (45 CFR Part 74.43).

- The state agency shall be alert to organizational conflicts of interest as well as noncompetitive practices among contractors that may restrict or eliminate competition or otherwise restrain trade (45 CFR Part 74.43). Because of this rule, the DSS requires its contractors to inform it whenever the contractors hire former state employees.

- State agency employees cannot participate in selection, or in the award or administration of a contract supported by federal funds if a conflict of interest, real or apparent, would be involved. Such a conflict would arise when the employee, an immediate family member, partner, or employer of any of the preceding has a financial interest in the contract (45 CFR Part 92.36)(b)(3).

# III. Effects and Fiscal Impact

SB 1467 had differing effects on the three sectors involved—i.e., state agencies, the CSU, and the UC—and on the two procurement areas—i.e., IT and non-IT. The fiscal impact of the bill is discussed separately for each sector. A table summarizing the comparative effects is presented in the Appendix.

## A. State Agencies

For IT contracts, there was a change in law, but little or no change in policy. SB 1467 extended to IT the following three provisions that previously applied only to non-IT contracts: (1) prohibition against follow-on consulting contracts, (2) financial conflicts of interest restrictions, and (3) revolving door restrictions. However, the prohibition against follow-on consulting contracts has been part of the SAM since June 1991, and thus has been state policy and practice for nearly 12 years. The follow-on consulting contract prohibition has also been included in procurement contracts or solicitation documents for over 10 years. The financial conflict of interest and revolving door procedures have been included in the California Master Award Schedule (CMAS) since CMAS's inception about eight years ago, and thus have been applicable to IT contracts using CMAS. Of the three provisions, only the prohibition against follow-on consulting contracts raised questions of a potential fiscal impact.

**Vendor Viewpoints.** During deliberations about the bill, some vendors expressed concern that the statutory prohibition against follow-on consulting contracts would increase costs to the State and result in delays as well as poorer quality services.[3] These vendors argued that firms that wanted to remain eligible for implementation contracts (which are more lucrative than consulting contracts) would not bid on contracts for feasibility studies or system design, which would reduce competition and diminish the quality of advice available to the State. Another aspect of the argument is that the IT industry would become divided, such that firms specializing in consulting would have no direct experience with implementation, which could diminish the quality of the consulting advice. Another aspect was that if departments were forced to change firms for different stages of the project, the second firm might have to duplicate some of the work of the first firm, which would cause delays and increase costs. Some vendors noted that departments have become very cautious in dealing with them lately, but acknowledged that the change was due to statewide concerns about procurement processes during 2002 and

[3] Five vendors were interviewed for this study. The vendors were selected by their affiliation groups (the Information Technology Association of America [ITAA] and American Electronics Association [AeA]) as being the most knowledgeable and involved with SB 1467.

not to SB 1467. Vendors were not able to provide specific examples to validate their concerns, which some admitted were theoretical.

Some vendors do not share these concerns. They believe instead that the bill would increase competition and is good public policy.

Some of the vendor representatives interviewed for this study were not aware that the prohibition on follow-on contracts had been State policy since 1991. In contrast, State department staff indicated that the vendor representatives with whom they deal directly are very aware of the prohibition, because the language is a standard component of State IT contracts; however, these representatives may not be aware that the prohibition is State policy via SAM.

**State Agency Viewpoints.** Based on interviews with several agencies,[4] the follow-on contract provisions are viewed as insignificant, unless the DGS changes its interpretation of the provisions, in which case the impact could be very significant. Departments understand the importance of preventing conflicts of interest and unfair advantage. Some departments solicit unpaid advice from vendors, sometimes in public forums, in order to become informed on current solutions available to address their business problems. Departmental staff noted that some firms decline to bid on feasibility studies or requests for proposal in order to remain eligible for implementation contracts, but indicated that there is such a large number of available firms that competition is sufficient and departments are able to get the quality of advice that meets their business needs. They noted that there are some firms that specialize in consulting only, but these firms hire staff with recent implementation experience, and there have been no problems due to lack of recent knowledge. One department reported that the restriction slows down the process, but did not quantify the delays. One department reported that in some contracts it is very careful to avoid asking for recommendations because it wants the firms bidding on the consulting contract to remain eligible for later phases. (In such cases, the consultant may be asked to gather information, but not make recommendations or proposals).

**Potential for Fiscal Impact.** Since the prohibition on follow-on consulting contracts has been State policy and practice for nearly 12 years, there should be no fiscal impact on state agencies. Indeed, several department staff interviewed indicated that there would be no change in practice and no fiscal impact. However, there are three circumstances under which there could be a fiscal impact from putting the provision into statute:

[4] Teale Data Center, Health and Human Services Agency Data Center, Franchise Tax Board, Department of Justice, Department of Employment Development, Department of Social Services.

- **Non-Adherence to SAM.** There would be an impact if departments have not been adhering to SAM. Since departments are required to adhere to SAM, it is unlikely that any would admit to violations. One department did acknowledge that it didn't always adhere to this provision of SAM in the past, but has done so in recent years. Some departments have been unclear about the validity of the SAM section, because it appeared inconsistent with statute (i.e., statute exempted IT from the prohibition against follow-on contracts), and some departments were under the incorrect impression that this SAM section had been deemed invalid by the DGS. Nevertheless, the departments with this impression stated that they did not engage in follow-on contracts, either due to federal rules governing the projects or to general principles of State law requiring open and unbiased competition.

- **Change in Interpretation.** There would be an impact if the DGS changed its interpretation of PCC Section 10365.5. The language of the law is very broad and requires interpretation, often on a case-by-case basis, and departments consult the DGS for advice. In the past, the CMAS contract provisions for IT cited the exact language of PCC Section 10365.5 as it appears in SAM Section 5202, and indicated: "Therefore, any consultant that contracts with a state agency to develop a feasibility study or provide formal recommendations for the acquisition of information technology products or services is precluded from contracting for any work recommended in the feasibility study or the formal recommendations." This interpretation is narrow, and according to the DGS it is also outdated, because the IT environment has become more complicated since that language was developed. For example, there are now consultants who perform project management and independent verification and validation. Departments have been relying on the DGS for advice in how to apply the follow-on contract prohibition. Some departments are concerned that there are grey areas in which the DGS might apply more stringent interpretations in the future given the stricter procurement environment and the fact that the follow-on contract prohibition is now in statute.

  There are numerous situations faced by departments today that are not clear:

  - **Example 1:** If a consultant studied a business problem and identified several options for addressing the problem but did not evaluate the options, would the consultant be eligible for a subsequent contract to evaluate the options? One department staff member who is very experienced in IT contracting provided contradictory answers to this question on different occasions.

- **Example 2:** If a consultant prepares the feasibility study report, can the consultant bid on the independent validation and verification? Such contracts occur now, but departmental staff are not sure they will be allowed in the future.

- **Example 3:** Initial maintenance and operations (M&O) is usually bid along with development and implementation. The contractor typically will make recommendations regarding M&O. Is the initial contractor precluded from bidding on the next M&O contract?

- **Example 4:** Can the same project management consultant advise the State on the feasibility study and on implementation? Under federal rules, a distinction is made between consultants working on behalf of the State and consultants working on their own behalf. Thus, under federal rules, there would be no conflict in a project management consultant continuing to assist the State in project oversight throughout the various project phases, and such contracts currently occur. However, state departments are quite worried that DGS might view the situation differently in the future, now that SB 1467 has been enacted and the general environment in procurement has become more stringent. Having to change project management consultants during a major new project could result in a significant costs, because the work completed by the first consultant would have to be duplicated by the second consultant and because the delays caused by changing contractors on federally mandated projects could trigger federal penalties if implementation deadlines are missed.

  Staff at the Health and Human Services Agency Data Center (HHSDC), which is currently implementing ten medium to large IT projects, indicates that changing project management consultants would cause a delay of about a year—i.e., six to nine months for the procurement process and about four months for the new contractors to acquire sufficient knowledge of the project to be productive. Given the phases of these types of projects, the project manager would probably have to be changed twice under a strict interpretation of the follow-on contract prohibition. Penalties for missing the federally mandated implementation deadlines are $400 million a year for the Electronic Benefit Transfer project and $165 million a year for the Child Support project. The four months of contractor learning would probably cost $190,000 each time the project management contractor changed.[5] Given the five project management contracts the HHSDC currently has, the fiscal impact could be $1.9 million over several years.[6] Also,

[5] Four months x 168 hours per month x 2 consultants x $140 per hour = $188,160.

[6] $190,000 x 5 contracts x 2 changes = $1.9 million. The projects typically take 4-6 years.

contractors incur costs to keep personnel available during the bidding process, so the costs of the project management contracts would also increase by an unknown amount. In addition to these fiscal impacts, HHSDC staff note a potential qualitative impact—i.e., a change in project management contractors often brings a change in perspective, which can affect the development and success of the project.

- **Involvement of the Courts.** Now that the follow-on contract prohibition is in statute for IT projects, the courts will have jurisdiction over the interpretation. In the past, vendors could only obtain an informal administrative hearing. In the only case litigated on the follow-on issue, a vendor-plaintiff pursued a case against the Department of Motor Vehicles (DMV) into court and won at the Superior Court level; however, the case was overturned and dismissed on appeal because there was no statute to support the plaintiff's assertion that a follow-on issue existed in the contract award. Future involvement of the courts could result in increased costs in several ways. There would be additional costs due to delaying projects in progress (delays in IT projects creates obsolescence), as well as costs of litigation. (For example, the DMV case took over two years to resolve, and in the interim, both the State and the vendor lost hundreds of thousands of dollars.) In addition, delays involving federal projects could result in federal penalties to the State. Finally, if court interpretations are stricter than those adopted by the DGS, there could be additional costs due to court requirements that a different contractor be employed. It should be emphasized that the risk of a court case is greater to the extent that DGS' interpretations are broader—i.e., the more flexibility that DGS allows departments, the more likely it is that vendors will seek to test permissible boundaries.

## B. California State University

**Previously Existing Policies.** The CSU is not subject to DGS policies or SAM, but has its own standard contracts and its own administrative manual as well as a Procurement Policy Manual. The conflict of interest provisions in the Procurement Policy Manual make no distinction between IT versus non-IT goods and services, so the policies apply equally to both types of contracts. Prior to SB 1467, CSU policy was to *reserve the right* to prohibit a contractor from receiving a follow-on consulting contract.[7] CSU stated that its actual practice was to prohibit follow-on contracts, although there was no written policy to require this practice. The Procurement Policy Manual (and the Education

[7] Procurement Policy Manual Section 412.10

Code) addressed revolving door issues by prohibiting current and former employees and contractors from deriving monetary gain from non-public information acquired as a result of their affiliation with the CSU.[8] CSU has its own section in the PCC, which includes some, but not all, of the contract related penalties addressed in SB 1467, however these apply only to construction projects.[9] CSU uses taxpayer identification numbers for vendors and places the numbers on the contracts.

**Statutory Changes in SB 1467.** SB 1467 imposed different requirements on non-IT versus IT goods and services.

- Non-IT Contracts: SB 1467 extended to the CSU's non-IT contracts all five provisions addressed in the bill, i.e., (1) prohibition against follow-on consulting contracts, (2) financial conflict of interest restrictions, (3) revolving door restrictions, (4) contract related penalties, and (5) contractor ID number. The CSU's non-IT contracts were historically subject to all these provisions, except during 2002, when the 2001 legislation exempting the contracts was effective.

- IT Contracts: Because SB 1467 applies the follow-on contracts prohibition, financial conflict of interest restrictions, and revolving door restrictions to state agency IT contracts, CSU may be required to adopt similar policies, although the legal requirement to do so is not clear. [10]

**CSU Policy Changes.** CSU has changed the Procurement Policy Manual to conform to SB 1467, effective March 3, 2003. Since the Procurement Policy Manual makes no distinction between IT and non-IT with respect to conflict of interest, both areas are covered equally. Section 210.04 of the Procurement Policy Manual contains the financial conflict of interest and revolving door provisions, and Section 412.10 of the Procurement Policy Manual contains the prohibition on follow-on contracts. Other provisions were also added to further tighten conflict of interest rules.

**Fiscal Impact.** The CSU has indicated that the conflict of interest provisions will have no fiscal impact on program operations, since there will be no essential change in policy or practice. The CSU has incurred ministerial costs to produce new policies, and will be increasing administrative oversight and coordination in the enforcement of the new policies, which will result in increased ongoing administrative costs. CSU already complies

[8] Procurement Policy Manual Section 210.04 and Education Code Section 89006.

[9] PCC Sections 10870-10874.

[10] The situation is ambiguous given the statutory structure. Provisions regarding non-IT contracts and IT contracts are in different chapters of the GC. The IT chapter exempts the CSU from the provisions of the IT chapter, but states that the CSU shall adopt its own policies and procedures that further the policies "**expressed in this [IT] chapter**" (GC 12100.5). The conflict of interest provisions are contained in the non-IT chapter, which also states that these provisions apply to IT. Thus, the conflict of interest provisions are not "expressed" in the IT chapter, to which CSU policies are required to conform. Therefore, there is no clear legal requirement for CSU to adopt policies regarding conflict of interest.

with the unique vendor identification number requirement, since it uses the vendor's taxpayer identification number on its contracts.

## C. University of California

Prior to SB 1467, the UC had extensive policies regarding conflict of interest (the list of policies alone is over four pages long), based largely on GC requirements prohibiting financial conflicts of interest and PCC competitive bidding laws applicable to the UC. However, these policies overlapped with only some of the provisions of SB 1467. SB 1467 created new sections of statute applicable solely to the UC. The sections address all five areas applicable to state agencies, and the language mirrors that for state agencies, with a few changes to accommodate situations unique to the UC. The new sections apply to all of UC, with no distinction between non-IT versus IT goods and services. Prior to SB 1467, UC was subject to none of these provisions. Also, given the way the PCC is structured, the provisions of SB 1467 apply to construction projects for the UC, but not for state agencies or the CSU.[11] Thus, the impact on the UC is more extensive than on state agencies or on the CSU, and has generated considerable concern and confusion. The bill is expected to result in a significant cost due to the prohibition against follow-on consulting contracts and the vendor identification requirements.

[11] Except that some penalties for violating contracting laws apply to CSU construction projects.

| SB 1467 Provision | Prior UC Policy | Expected Impact |
|---|---|---|
| Follow-on Consulting Contracts | None. | Significant cost. Estimated range of $4.4 million to $15.2 million annually. |
| Financial Conflict of Interest | No acquisition of goods or services may be made from any employee or near relative unless the goods or services are not otherwise available.[12] | UC could no longer contract with UC employees, even if goods or services are not otherwise available. Impact is qualitative, not fiscal. |
| Revolving Door | Adhered to one-year and lifetime bans in GC Sections 87401 and 87406, but permitted rehire of separated or retired employees under contract. | UC remains concerned about ability to temporarily rehire separated employees during personnel transitions. Impact is qualitative, not fiscal. |
| Penalties | None. | UC staff are confused regarding how legal penalties would be applied, since (unlike for state agencies) most of UC's contracting rules are in policy and not statute. Also, staff could find no case law to define the term "corruptly perform." |
| Contractor ID Number | Numbers assigned at campuses. | Costs to re-program contractor databases and maintain ongoing coordination for single university-wide system. Costs are unknown but may be several hundred thousand dollars on a one-time basis and $50,000 annually. |

**Follow-On Contracting Within UC**. UC policies on consultants specify that for contracts of $15,000 or more, the responsible administrator must assure that proposals are solicited from three or more qualified independent consultants, if possible. If a sole source contract is used, the reason must be documented, and the responsible administrator must determine that the price is reasonable. Contractors are selected based not on lowest cost alone, but on total value, i.e., qualifications, experience, resources, needs of the UC, as well as cost.[13] UC's policies do not prohibit follow-on contracts, which are used with some frequency.

[12] UC Business and Finance Bulletin BUS-43, Part 7, Section II, Paragraph C.

[13] UC Business and Finance Bulletin BUS-34, Section II, Paragraph J, and Section VII, Paragraphs D and F.

UC staff described the cost of prohibiting follow-on contracts in three areas: (a) architectural and engineering services; (b) academic medical centers; and (c) general procurement. It must be emphasized that there are no quantitative data for computing such costs. These estimates of necessity are based on professional judgment and experience. The combined estimate for the three areas ranges from $4.4 million to $15.2 million, and is further described below.

- **Architectural and Engineering Services.** In construction projects, UC usually allows the firm that conducted the preliminary design to compete for working drawings. When the contractor for the working drawings differs from the preliminary design contractor, UC staff estimate that about 2 percent to 4 percent of the design work must be duplicated (based on discussions between several staff members). Most of the impact is on non-state projects. (The timeline for state projects is extended due to the capital outlay budget process; therefore, the same contractor is less frequently used for both phases.) Based on working drawing costs of $70 million for non-state projects in 2002, UC estimates the annual fiscal impact from duplicative work to be $1.4 million to $2.8 million (i.e., $70 million times 2 percent to 4 percent).

  It should be noted that the prohibition against follow-on contracts in construction do not apply to state agencies or the CSU, because construction contracting laws for those entities are in different chapters of the PCC than the prohibition against follow-on contracts. However, all the UC contracting laws are in a single chapter, so the prohibition applies to all UC contracts.[14]

- **Academic Medical Centers.** Academic medical centers are highly specialized and complex institutions that conduct teaching and research as well as provide medical care. According to UC staff, consultants utilized by academic medical centers are also very specialized—there are very few firms that are able to provide management advice or IT products and services to academic medical centers. Thus, in the medical centers, follow-on contracts are common.

  One example of such a firm is the Hunter Group. UC staff emphasized that the Hunter Group's expertise makes its services unique, and that it is the sole source for the services that it provides. This firm has a $1.9 million contract with the UC Los Angeles (UCLA) Medical Center to assess various functions. If a new con-

[14] Construction contracting laws for state agencies are located in Chapter 1, Part 2, Division 2 of the PCC. Laws governing goods and services as well as conflict of interest are in Chapter 2, while laws governing information technology are in Chapter 3—these laws apply to state agencies and to some extent to the CSU. CSU's construction and other contracting laws are in Chapter 2.5. All laws applying to UC contracts are in Chapter 2.1.

tractor is required for the next phase, UC staff estimate that about one-third of the work would have to be duplicated (primarily interviews), for a fiscal impact of about $600,000. (Note: The Hunter Group also received a $2 million contract several years ago to help dissolve the union between the UC San Francisco (UCSF) Medical Center and Stanford, and then continued to work with UCSF to develop a strategic plan, which was essentially a follow-on contract of about $4 million to $5 million.)

In another example, the UC Davis Medical Center was required to expand its IT system in order to meet an accreditation deadline. A single firm with specialized expertise was hired for $100,000 to analyze the problem and provide the software to fix it. UC staff indicated that if a second firm had been required for the implementation, the medical center would have spent an additional 25 percent, or $25,000, and not met the deadline.

Another example is a $60 million database project at the UC Davis Medical Center to improve patient safety, as required by legislation.[15] The consultant costs are $30 million over five years. UC staff estimate that a requirement to use different firms for various phases of the project would increase costs by about 25 percent, or $7.5 million over five years.

UC staff indicate that its five medical centers have a total of about 50 to 75 contracts per year, at a typical cost of about $250,000 to $1 million each. Thus, total contracts are about $12.5 million to $75 million annually. UC staff did not provide an estimate for the fiscal impact, but if half the contracts are follow-on contracts, and the increased cost of changing consultants is 25 percent, then the annual fiscal impact would be $1.5 million to $9.4 million annually (i.e., [$12.5 million to $75 million] times 0.5 times 0.25).

It must be noted that although academic medical centers deal with more complex cases and have additional teaching responsibilities, they must compete for patients with other hospitals in their communities. Other hospitals are not subjected to the same legal prohibition against follow-on contracts, and thus the prohibition is a competitive disadvantage for UC.

- **General Procurement**. The fiscal impact on general procurement was based on the UCLA campus, which spent about $66 million on consulting services in fiscal year 2000-01 (excluding architecture and engineering and the medical center).

[15] Chapter 816, Statutes of 2000 (SB 1875).

Since UCLA comprises about one quarter of systemwide spending, UC as a whole spends an estimated $250 million annually on consultant services. UC's staff have no information about the proportion of follow-on contracts, but believe it is significantly less than half. Staff developed an estimate was based on the assumption that 20 percent, or $50 million worth, of the contracts are follow-on—this estimate could be high. Procurement staff utilized the architectural and engineering assumption that about 2 percent to 4 percent of the work would need to be duplicated—this estimate could be significantly low, since firms doing working drawings have documented preliminary plans to follow, and other types of consulting are more varied. In addition, UC staff believe that if consultants know they will be ineligible for follow-on work, they will raise the prices of their contracts by an estimated 1 percent to 2 percent, because the opportunity to make a profit on the contract will be more limited. Thus, UC staff assume that the total impact will be a 3 percent to 6 percent increase on a $50 million base, or $1.5 million to $3 million. Given the uncertainty in developing any estimate, this does not appear to be unreasonable.

**Vendor Identification Numbers**. Within UC, vendor identification numbers are assigned by the campuses based on vendor billing address (for invoicing), so an individual vendor may have more than one number. In addition, taxpayer identification numbers are stored for taxable income reporting, and are used as needed to generate systemwide reports of unduplicated information by vendor. The taxpayer identification number does not appear on contract documents in order to protect vendors from identify theft.

It appears that SB 1467 requires a single number per vendor regardless of campus. UC would have to establish a centralized number assignment function accessible to the campuses, and modify existing campus systems to accommodate an additional information field (both the address-related number and the taxpayer identification number would still be necessary). The system would require ongoing maintenance. UC estimates that the total cost would be several hundred thousand dollars on a one-time basis, plus ongoing costs of at least $50,000 annually.

UC staff believe that the language of SB 1467 can be interpreted to allow individual campuses to assign unique identification number. If this interpretation is deemed legally correct, then UC would not have to establish a centralized number assignment system, which would reduce one-time costs significantly, and eliminate all or most of the ongoing costs.

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# IV. Conclusions and Recommendations

The fiscal impact of SB 1467 is primarily due to the prohibition against follow-on contracts. The impact on state agencies may be non-existent or significant, depending on how the DGS interprets the law and advises departments, and on how the case law develops. A strict interpretation could result in missed deadlines on federally mandated projects that could subject the State to penalties of hundreds of millions of dollars in addition to increased contracting costs. The fiscal impact on the CSU will probably be minor. There will be an impact on the UC, estimated to be about $4.4 million to $15.2 million annually. The broad and absolute language of the law has created uncertainty and concern. The fiscal impacts and the concerns could be mitigated with measures described below.

## A. Need for Guidelines and Notification

The DGS should work with state agencies and the Department of Finance's Technology Investment Review Unit to develop a management memo that notifies state agencies of the statutory changes and provides guidelines regarding follow-on consulting contracts. Most State agency employees interviewed for this study were unaware that SB 1467 had been enacted—they need to know that the requirements are now statutory and not administrative policy. The management memo should indicate how the law should be interpreted and applied in a variety of situations that state agencies encounter, similar to the information provided in federal regulations. The management memo should allow for continuation of current practices to the maximum extent possible within the requirements of the law, in order to minimize delays and additional costs to IT projects. The issuance of such guidelines via management memo would be useful to state agencies and should help alleviate vendor concerns that they must change the way they do business with the State.

The DGS has made an effort in this direction in its January 2003 revision to the standard terms and conditions for IT contracts. However, the new language is simply part of the model contract, and is not part of a focused communication to state agencies. In addition, the DGS worked only with vendors and outside legal counsel—state agencies were not involved, and the new language does not address all their concerns. Thus, there is a need for additional guidance and communication.

## B. Statutory Exemption

It may be beneficial for the statute to be amended to allow for exemptions to the law under exceptional circumstances, such as when there is no real competition and/or it is clearly in the State's best interest e.g., to avoid a large federal penalty. An exemption was possible when the IT follow-on contract prohibition was confined to SAM. The DGS reported that issues were so rare that since 1991, written approval for exemptions were sought and received perhaps no more than two or three times. In the absence of an exemption process, the State may upon rare occasion, such as with a highly specialized area, be unable to find a contractor or be forced to settle for a poorly qualified contractor.

The DGS should work with the author's office to develop an amendment that would permit exemptions under extraordinary and well-justified circumstances, while protecting the State from improper influence to the maximum extent possible.

## C. Exemptions for UC Construction and Medical Centers

Within UC, the biggest fiscal impact is in the academic medical centers. These facilities are unique in state government, so there is no equity that is achieved by applying this provision to them. Since the availability of qualified consultants in this area is so limited, it is unclear what benefit is derived from applying this provision to the academic medical centers when it may be detrimental to their operations and competitiveness. It is also unclear why UC construction projects should be subject to the prohibition against follow-on contracts when other state construction projects are exempted. The fiscal impact of the bill would be substantially mitigated if the UC's construction program and medical centers were exempted from the prohibition against follow-on consulting contracts. (Note: SB 41 of the current (2003-04) legislative session is addressing the exemption for construction-related consulting contracts.)

## D. Modification of Contractor Identification Number Requirements

The UC has a campus-based system that assigns identification numbers to contractors, and UC would incur additional costs to meet the SB 1467 requirement for a unique systemwide vendor identification number. It is not clear what benefit would be provided from a systemwide number, since systemwide reports by vendor can be obtained as needed from current databases. It should be noted that although the same requirement

applies to state agencies, the DGS was not aware of it until recently, and actual practice differs. The DGS maintains a unique identification number for all contracts that it tracks, but state agencies do not use this number, and some contracts are not tracked by the DGS. This vendor identification number does not appear on contracts. State agencies track taxpayer identification number for taxable income reporting, but this number also does not appear on contracts. Given the uncertain benefit, the additional costs, and the inconsistent application of this provision in state government, the extension of this requirement to the UC should be revisited. If the requirement is retained, the language should be clarified to indicate if the numbers are to be assigned centrally or by campus.

In addition, it is not clear what is meant by the requirement to use the "president's assigned number" for corporations and firms. Procurement officials at the DGS are unclear of the meaning of this phrase as it applies to state agencies (in PCC Section 10412). It could refer to the president of the firm or corporation, or it could mean the taxpayer identification number as assigned by the President of the United States (via the Internal Revenue Service). For CSU, it could mean the campus president. For UC, it could mean the President of the University. Statute should be amended to clarify or delete this requirement (amendments would be needed to PCC Section 10412 for state agencies and the CSU, and to PCC Section 10518 for the UC).

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# Appendix

## Applicability of Conflict of Interest and Related Provisions, Before and After SB 1467

| | | Statutory Provisions Before and After SB 1467 | | | | |
|---|---|---|---|---|---|---|
| | | Follow-On Consulting Contracts | Financial Conflict of Interest | Revolving Door | Contract-Related Penalties | Contractor ID Number |
| **State Agencies** | | | | | | |
| Non-IT | Before | Yes | Yes | Yes | Yes | Yes |
| | After | Yes | Yes | Yes | Yes | Yes |
| IT | Before | Yes, via SAM | Via CMAS only[1/] | Via CMAS only[1/] | No | No |
| | After | Yes | Yes | Yes | No | No |
| **CSU** | | | | | | |
| Non-IT | Before [2/] | No (2002 only) | No (2002 only) | No (2002 only) | No (2002 only) | No (2002 only) |
| | After | Yes | Yes | Yes | Yes | Yes |
| IT | Before | No | No | No | No | No |
| | After | No[3/] | No[3/] | No[3/] | No | No |
| **UC** | | | | | | |
| IT & Non-IT | Before | No | No | No | No | No |
| | After | Yes | Yes | Yes | Yes | Yes |

[1/] CMAS contracts for IT have contained these provisions since the inception of CMAS about eight years ago.

[2/] Prior to 2002, CSU contracts for non-IT goods and services were subject to essentially the same provisions as state agencies. Legislation enacted in 2001 exempted CSU from all the provisions applied to state agencies (Chapter 219, Statutes of 2001 [AB 1719]).

[3/] CSU is required by law to adopt policies and procedures for IT that are similar to those applicable to state agencies. Thus, while the statutes do not directly apply, CSU may be legally required to adopt similar policies regarding follow-on contracts, financial conflicts of interest, and revolving door restrictions. Regardless of the legal ambiguity, CSU has already adopted policies that apply these provisions to IT.